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TAX SHELTERS, TAX LAW, AND MORALITY: CODIFYING JUDICIAL DOCTRINES

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IN his book, *Playing by the Rules*, Professor Frederick Schauer accepts as a truism that "the precepts of morality need not be as detailed as those contained in the Internal Revenue Code."[1] Tax lawyers usually favor precise rules and criticize the courts' application of broad standards. In recent testimony about corporate tax shelters to the Senate Ways and Means Committee, for example, Lindy Paull, Chief of Staff of the Joint Committee, praised the "the tax system's reliance on objective rule-based criteria."[2] Similarly, in delivering the Fourth Annual Lawrence Neal Woodworth Memorial Lecture, Kenneth Gideon, former Assistant Secretary for Tax Policy, called for reducing "our reliance on antiabuse rules and litigation over uncertain 'smell' tests in favor of directly providing administrable rules through legislation and the published guidance process."[3]

In the recent debates about corporate tax shelters, however, the pattern has reversed. Many private practitioners and corporate executives have decried with a moral fervor governmental attempts to codify and, in so doing, define more precisely in statutes or regulations such broad judicial anti-avoidance doctrines as business purpose or economic substance. This criticism has targeted the statutory proposals in the President's Budget Proposals and in the Senate Finance Committee's Corporate Tax Shelter Preliminary Discussion Draft.[4] The partnership anti-abuse regu-

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1. FREDERICK SCHAUER, PLAYING BY THE RULES 12 (Clarendon Press 1991).

2. Lindy Paull, *Testimony of the Staff of the Joint Committee on Taxation Before the Committee on Ways and Means*, 1999 Tax Notes Today 218-20 (1999), *available at* LEXIS, Fedtax Library, TNT File.

3. Kenneth W. Gideon, *A Good Tax System: Transparent, Simple, and Fair*, 81 TAX NOTES 999, 1004 (1998).

4. *See* DEPARTMENT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2001 REVENUE PROPOSALS (Feb. 2000); Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal*, 2000 TAX NOTES TODAY 46-14 (2000), *available at* LEXIS, Fedtax Library, TNT file; Senate Finance Committee, *Corporate Tax Shelters*, 2000 TAX NOTES TODAY 102-09 (2000), *available at* LEXIS, Fedtax Library, TNT File; DEPARTMENT OF THE

lations provoked similar but even more strident opposition.[5] Animus has been directed not only at the substance of the rules and whether they are effective or administrable, but also at the very attempt to write them. For at least some members of the tax bar, judicial anti-abuse standards have suddenly become a cause for celebration rather than dismay.

The issues raised by the debate about legal rules versus standards are not unique to tax shelters or tax law. The premise of this article is that theoretical examinations of the working and interpretation of rules, such as Professor Schauer's,[6] can illuminate and perhaps advance this and other tax debates. In his book Schauer posits a close relationship between rules and their justifications. He further argues that rules not only foster predictability, reliance, and certainty, but also serve as devices for the allocation of power.[7] This paper uses Schauer's work to suggest that the recent corporate tax debate has conflated concerns about the appropriate level of generality for tax shelter anti-avoidance rules with concerns about separation of power, failing to sort out the relationship between these different aspects of rules. Taking these concerns as separate parts of any analysis clarifies the issues at stake and their possible resolution. In particular, such an analysis underscores the extent to which parties to the debate disagree about the impact of such codified rules on judges, administrative agents, and tax professionals.

This paper looks at purposive common law doctrines and their codification from a distance, at a general level. It does not attempt to analyze the content of any proposed codification, proposed improvements to them, or to compare the impact of substantive requirements to different kinds of approaches, such as increasing penalties. Instead, it uses the occasion of the current tax shelter debate to consider the perennial, recurring issues about rules versus standards and their codifications. This approach is necessarily incomplete. Nonetheless, I believe that such a general analysis will aid in the task confronting the tax community of working out an approach to corporate tax shelters and other similar issues.

Part I of the paper summarizes Schauer's approach to rules and their justifications. Part II applies his concepts to the tax shelter debate. Part III explains that codification of broad standards raises important concerns about excessive exercise of administrative discretion, but that the administrative process in general and the tax administrative process in particular tend to operate to limit administrative discretion. The last section observes that private parties are concerned about the errors of ad-

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TREASURY, WHITE PAPER: THE PROBLEM OF CORPORATE TAX SHELTERS (DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS) (July 1999).

5. *See infra* notes 81-85 and accompanying text.

6. For other considerations of rules, see, e.g., Jules L. Coleman, *Rules and Social Facts*, 14 HARV. J.L. & PUB. POL'Y 703 (1991); Anthony D'Amato, *Can Legislatures Constrain Judicial Interpretation of Statutes?*, 75 VA. L. REV. 561 (1989); Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65 (1983); Ronald M. Dworkin, *The Model of Rules*, 35 U. CHI. L. REV. 14 (1967); Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974).

7. *See* SCHAUER, *supra* note 1.

ministrative officials, while administrative officials are concerned about the errors of private parties. In the absence of empirical data about the size of the problem, resolution of this disagreement must be a matter of informed judgment, a best guess. Professor Schauer's analytical framework will enable us to ask more precise questions in making this judgment.

I. SCHAUER'S THEORY OF RULES

Professor Schauer undertakes a consideration of rules at their most general level of application, what he calls a "philosophical examination." In his book, he mentions tax laws only a few times in passing.[8] Moreover, he does not limit himself to legal rules, although law is an important focus of the work. Since tax laws are one subset of legal rules and legal rules a particular subset of rules, his discourse raises many of the same points as those that have been raised in the debate about tax shelters. His disinterested, neutral and theoretical consideration of rules and their operation along with his analysis of the different kinds of justifications for rules provides a useful lens through which to view the current tax debate. The following summarizes this work for purposes of this paper, although it necessarily oversimplifies his nuanced and ambitious undertaking.

Rules, Schauer explains, are generalizations and "[b]ehind every generalization is a justification. Sometimes called goals, sometimes purposes, or sometimes even (confusingly) reasons, justifications exist because normative generalizations are ordinarily instrumental and not ultimate, and justifications are what they are instrumental to."[9] Generalizations, in the form of rules, narrow justifications. They "*specify* the result that will usually be obtained from direct application of their justification."[10] Justifications themselves exist on different levels so that "there may be stacked layers of rules" with comparatively specific justifications themselves having "deeper and yet more abstract justifications."[11]

Schauer is not advancing a primarily linguistic, literary or rhetorical argument.[12] Under Schauer's analysis, purposes or justifications neither supply a maxim of statutory interpretation nor aid in parsing the rule. Rules and justifications are closely bound together, with a justification having an analytical priority over the rule.[13] Decision-makers resort to justifications when the language of the rule produces a result seemingly

8. *See* SCHAUER, *supra* note 1, at 13-14, 102, 119, 207.

9. SCHAUER, *supra* note 1, at 53.

10. *Id.*

11. *Id.* at 73.

12. As he explains, "rules and their formulations *are* different . . . . [W]e commonly distinguish different rules according to what they do, rather than how they say it." SCHAUER, *supra* note 1, at 63.

13. Unfortunately, Schauer does not tell us how we identify a rule's justification or justifications or discuss whether conflicting justifications can exist; he seems to assume that the justification is clear. Fortunately, the judicial anti-abuse doctrines provide the justifications in the case of tax shelters.

inconsistent with its purpose, rather than when the language of the rule is ambiguous.

For Schauer, rules become interesting when they are under- or over-inclusive, that is, "when a particular application of a rule generates a result divergent from that which would have been generated by direct application of the rule's justification."[14] In the case of such a divergence, he identifies two basic decision-making modes:

> Under one mode, the decision-maker treats the pre-existing generalization of a rule as if it arose in conversation, modifying it when and as it is unfaithful to the rule's underlying justifications. The existing generalization operates merely as the defeasible marker of a deeper reality. It is transparent rather than opaque, and a decision-maker operating in this mode is expected to look through that transparent generalization to something deeper when recalcitrant experiences present themselves.[15]

By contrast, rule-based decision-making offers an alternative mode of decision-making. It would have a decision-maker "treat the generalization of a rule as entrenched, prescribing (although not necessarily conclusively) the decision to be made even in cases in which the resultant decision is not one that would have been reached by direct application of the rule's justification."[16] For such a decision-maker generalizations are more than mere indicators.[17] Here, generalizations supply "reasons for decision independent of those supplied by the generalization's underlying justification."[18] In this second mode, the rule gives the decision-maker a reason for decision even when the application of the rule in the particular circumstance "does not serve its generating justification."[19]

Schauer goes on to elaborate a third method of decision-making, one that combines elements of both these decision-making modes. With this third mode of decision-making, Schauer issues an important caution to any decision-maker weighing application of a rule against its justification. He calls upon a decision-maker in this circumstance to consult "both substantive justifications and the justifications for specifying those justifications in the form of a rule."[20] The justifications for specifying justifications in the form of a rule, he explains, "are commonly seen to serve the goals of certainty, reliance, and predictability."[21] In this mode, a decision-maker may adhere to a rule even when direct application of the justification behind the rule would produce a different result because, for example, of "the rule-generating justification of lessening addressee uncertainty."[22] A "particularistic decision-maker aware of the value of

14. SCHAUER, *supra* note 1, at 72.
15. *Id.* at 51.
16. *Id.*
17. *Id.*
18. *Id.*
19. SCHAUER, *supra* note 1, at 76.
20. *Id.* at 94.
21. *Id.* at 95.
22. *Id.* at 95-96.

rules" must consider "the effect on future conduct of deciding according to the substantive justification rather than according to the rule."[23]

That is, the decision-maker sometimes will and sometimes will not conclude that the values supporting the substantive justification outweigh the consequences of diminished certainty, reliance, and predictability.[24] By virtue of asking such questions, a decision-maker can engage in "rule-sensitive particularism," a procedure that appears to take account of the virtues of rules without at the same time "elevating those rules into an absurd position of formal importance purely for formality's sake."[25] In short, "if the virtues of rules are seen to reside largely in the fostering of predictability, reliance, and certainty, then rule-sensitive particularism appears to take account of these virtues without committing the sin of rule-worship."[26]

When he focuses on law as a set of rules, Schauer modifies rule sensitive particularism into what he dubs "presumptive positivism."[27] Rules have priority over their justifications but "that priority exists only as a presumption, subject to being overcome in particularly exigent cases."[28] Often, the justification or justifications for the rule constitute the exigency needed to override it. Sometimes other values or justifications, including non-legal ones, apart from those behind the particular rule provide the exigency.[29]

Schauer, in a move that I believe to be of particular relevance to the current debate about tax shelters, urges that "we see rules not so much as implements for achieving predictability but as devices for the allocation of power."[30] Rules are jurisdictional. If we take such a view, "then it is far from clear that granting the power to a rule-applier to determine whether following the rule is on the balance of reasons desirable on this occasion is necessarily desirable."[31] He further explains:

> [I]f the designer of a decision-making environment is guided by a concern that certain decision-makers not make certain kinds of decisions, it appears psychologically counterintuitive . . . to authorize decision-makers to determine in each case whether this is the kind of decision with respect to which they should not be trusted. . . . To have an agent operating in one jurisdiction determine if this is a case in which she should invade the decision-making jurisdiction of another is in substantial tension with the very idea of jurisdictional separation.[32]

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23. *Id.* at 96.
24. SCHAUER, *supra* note 1, at 96.
25. *Id.* at 97.
26. *Id.* at 98.
27. *Id.*
28. *Id.* at 191.
29. SCHAUER, *supra* note 1, at 200-02. Schauer discusses the use of more general values and norms to override rules under presumptive positivism in Frederick Schauer, *Rules and the Rule of Law*, 14 HARV. J.L. & PUB. POL'Y 645, 675-79 (1991).
30. *Id.* at 98.
31. *Id.*
32. *Id.* at 98-99.

Some "withdrawals of decisional jurisdiction are based on a distrust of decision-makers—on a fear that some types of decision makers, when empowered to consider certain kinds of facts, reasons, and arguments, will consider them unwisely and thus produce mistaken decisions."[33] While some matters of jurisdiction result from explicit jurisdictional rules, other limits on decisional discretion may be a matter of policy or culture. "[E]ven when judges and other legal officials are given narrow and specific prescriptions with which to work," different sets of officials may differ in the extent to which they are "instructed or compelled to treat the prescriptions as opaque mandatory rules rather than transparent rules of thumb."[34]

Schauer directs us to examine both decision-makers and decision-making environments. He recommends that "[i]n a world of non-ideal decision makers, therefore, one should calculate the virtues of ruleness based not only on an assessment of the costs of errors of under- or over-inclusion, but also on an assessment of the incidence and consequences of those errors that are more likely when decision-makers are not constrained by rules."[35]

Both strands of Schauer's analysis—presumptive positivism and the different kinds of justifications for rules—bear upon the current and other debates about rules versus standards. By sorting suggestions and commentary in this debate along both of these dimensions, we will be better able to identify areas of agreement as well as disagreement. His analysis gives a new take on both those who defend and those who attack use of standards or justification.

II. APPLYING SCHAUER'S INSIGHTS

Although Schauer's failure to explore in detail how decision-makers should identify justifications for rules is a serious flaw in his analysis, in the case of corporate tax shelters, the justifications at issue are already identified—the doctrines of economic substance and business purpose—even if the precise content of these accepted justifications itself provokes disagreement.[36]

As Schauer acknowledges in an article published the same year as his book, what he calls the justification behind a rule, others refer to as "'discretion' or the application of 'standards.'"[37] The tax debate is usually couched in terms of rules versus standards, and thus, I will use the terms "standards," "purpose," and "discretion" as well as his term "justification."

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33. *Id.* at 158.
34. *Id.* at 173.
35. Schauer, *Rules and the Rule of Law*, *supra* note 29, at 685.
36. *See, e.g.*, David Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235 (1999); Robert Thornton Smith, *Business Purpose: The Assault Upon the Citadel*, 53 TAX LAW. 1 (1999).
37. Schauer, *Rules and the Rule of Law*, *supra* note 29, at 653.

The following discussion will consider four aspects of Schauer's analysis: (1) the close relationship between rules and their justifications; (2) the traditional values of predictability, reliance, and consistency associated with rules; (3) rules as instruments of separation of powers; and (4) the importance of considering the incidence and consequence of errors. It will apply these considerations to both judges and administrative officials.

The first two of these considerations—the need to take account of not only the rule but also its justification and the need to consider the values of resorting to rules to carry out justifications—define presumptive positivism. Accepting presumptive positivism, at least for the next few pages, has significant consequences for many aspects of the recurring debate regarding rules and standards in the tax law. Presumptive positivism affects how we understand both the judicial doctrines themselves and any codification of them.

Consider first judicial use of anti-abuse standards. In the corporate tax shelter controversy, commentators have extolled the judicial anti-abuse doctrines and even supported their expansion. The Tax Section of the New York State Bar Association, for example, objects to codifying the economic substance rule in part on the grounds that such a rule would "undermine the common law economic substance doctrine itself."[38] It urges that if any such rule is enacted, it "clearly provide that it does not supplant case law doctrines . . . and is not intended to discourage the courts from applying or expanding these doctrines."[39] Lee Sheppard of Tax Analysts has written, "it is the contention of some opponents of tax shelter legislation that the government's recent court victories obviate the need for new tax shelter laws."[40]

Endorsement of the common-law doctrines is not, however, universally shared. Traditionally, many have argued that judicial doctrines invoking justifications or standards have no place in a highly articulated set of rules such as the tax code. They take the position that judges have no authority to ground decisions on such standards and that opinions on this basis lack legitimacy. Professor Joseph Isenbergh has eloquently made the case against "extrastatutory" standards, "an additional (and somewhat autonomous) set of principles for deciding tax disputes."[41] Instead, he en-

38. Robert H. Scarborough, *NYSB Tax Section Concerned About Codifying Substance Doctrine*, 2000 TAX NOTES TODAY 146-25 (2000), *available at* LEXIS, Fedtax Library, TNT File.

39. *Id.*

40. Lee A. Sheppard, *Analysis: COLI Scam Gets Well Deserved Pummeling*, 85 TAX NOTES 569, 569 (1999).

41. Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 864 (1982); *see* John F. Coverdale, *Text as Limit: A Plea for a Decent Respect for the Tax Code*, 71 TUL. L. REV. 1501 (1997); Deborah A. Geier, *Commentary: Textualism and Tax Cases*, 66 TEMP. L. REV. 445 (1993); Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492 (1995); Michael Livingston, *Practical Reason, "Purposivism," and the Interpretation of Tax Statutes*, 51 TAX. L. REV. 677 (1996); Lawrence Zelenak, *Thinking About Nonliteral Interpretations of the Internal Revenue Code*, 64 N.C. L. REV. 623 (1986). Isenbergh's phrase "judicial intuition" captures nicely the prob-

dorses the principle espoused by Judge Sternhagen in *Gregory v. Commissioner*,[42] finding for Mrs. Gregory that "[a] statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration."[43] As Professor Isenbergh would have it, "[w]hen we are dealing with statutory terms of art, the form-substance dichotomy is a false one. 'Substance' can only be derived from forms created by the statute itself. Here there is form and little else; there is no natural law of reverse triangular mergers."[44] Isenbergh believes that had *Gregory* gone the other way, "we would now have a more readily fathomable demarcation between the respective spheres of statutory provisions and judicial intuition."[45]

Presumptive positivism might ultimately agree with Isenbergh and award victory to Mrs. Gregory, but it would do so on very different grounds. It would deny that statutory terms of art crowd out justifications. In this view of rules, substance creates, rather than being derived from, the forms in the statute. We may distance rules from their justifications, but under Schauer's view, recourse to justifications is always legitimate. It may, however, not be prudent. Presumptive positivism demands that the decision-maker also consider the justifications for narrowing justifications in the form of a rule. In the case of a meticulously drafted statute, such as the reorganization provisions at issue in *Gregory*, those justifications would be particularly strong and could well lead a judge following presumptive positivism to side with Mrs. Gregory. As Judge Hand himself put it in *Gregory*, "as the articulation of a statute increases, the room for interpretation must contract."[46]

A belief that judges often fail to weigh sufficiently the Big Three justifications for rules (certainty, predictability, and reliance) lies at the heart of most critiques of cases that apply the judicial anti-abuse standards. Thus, Kenneth Gideon tells us that the basic defect of all anti-abuse rules is uncertainty: "There is no clear delineation between situations in which the rule applies to deny benefit and those in which it doesn't. . . . . [[T]he ACM case] leaves us far short of a transparent, understandable, and administrable rule to explain the outcome of the case—and more important still—to predict the outcome of the next case."[47] Here, Gideon speaks as a presumptive positivist, asserting that in the case of the tax law, rule-generating justifications are especially strong. He is just as much of a presumptive positivist when he also urges that "particularly aggressive cases should be litigated for their exemplary value."[48]

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lem with Shauer's analysis identified above—the failure to identify the source or appropriate content of justifications.

42. 27 B.T.A. 223 (1932), *rev'd*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).
43. *Id.* at 225.
44. Isenbergh, *supra* note 41, at 879.
45. *Id.* at 883.
46. Gregory v. Helvering, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).
47. Gideon, *supra* note 3, at 1001 (citing ACM P'ship v. Comm'r, 157 F.3d 231 (3d Cir. 1998)).
48. *Id.* at 1004.

As Gideon's position demonstrates, judicial use of such standards is now well-established and long sanctioned by Supreme Court opinions.[49] Those who accept judicial use of anti-abuse doctrines may nonetheless criticize their codification as statutes or regulations. To the extent codification takes the form of regulations, critics go so far as to deny administrative agencies the authority to promulgate such an approach. This position surfaced most sharply when the Department of the Treasury proposed a broad partnership anti-abuse rule under section 701 of the Internal Revenue Code.[50] The American Bar Association, Section of Taxation, Committee on Partnerships, asserted that a regulation that would deny partnership transactions the benefits of the Subchapter K on the basis that certain transactions were inconsistent with the purpose of Subchapter K was invalid because it did "not interpret the language or meaning of section 701 under which it is being promulgated."[51] Similarly, in the corporate tax shelter debate, Kenneth Kies has demanded, "If we cannot rely on the language of the statutes and regulations, then what are we supposed to rely on?"[52]

Many have criticized such a theory of language and statutory interpretation. For example, Professor Johnson writes, "[I]t is sometimes assumed by the formalistic school of interpretation that the tax law must be clear and simple and that the taxpayer must benefit, and government must suffer, from any ambiguities or misinterpretations of the tax law. . . . [T]he English language and human understanding never reach the level of perfection that the formalistic school expects."[53] Like Professor Johnson, others who take a less formalistic view of language also have characterized the business purpose and economic substance doctrines as rules of statutory and regulatory interpretation that seek "to interpret statutory rules rather than add new requirements to them."[54]

Schauer would quarrel with this understanding as well. To call the application of a standard "statutory interpretation" is misleading. One of the most important lessons of *Playing by the Rules* is that decision-makers who conclude that a rule is inconsistent with its purpose are not interpreting the particular language of the rule. In the case of the common law tax doctrines, characterization as interpretation narrows these doctrines in a

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49. *See infra* note 121 and accompanying text. Commenting on *Gregory v. Helvering*, legislative history has endorsed courts "for a commendable tendency to look through the mere form of the transaction into its substance." H.R. 704, 73d Cong., 13 (2d Sess. 1934).

50. Section 701 states: "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." I.R.C. § 701 (1986).

51. William H. Caudill, *Comments Concerning Proposed Regulation Under Section 701 of the Internal Revenue Code of 1986*, 94 TAX NOTES TODAY 146-50 (1994), *available at* LEXIS, Fedtax Library, TNT File.

52. Kenneth J. Kies, *Letter to the Editor: Corporate Tax Shelters: It's Time to Come to Terms With the Data*, 88 TAX NOTES 133 (2000).

53. Calvin Johnson, *The Anti-Skunk Works Corporate Tax Shelter Act of 1999*, 84 TAX NOTES 443 (1999).

54. Scarborough, *supra* note 38. Courts have also taken such a position. *See* Saba P'ship v. Comm'r, 1999-359 T.C. Memo, Par. 105 (1999).

way that does not adequately reflect how they are used. The common law doctrines are more than guides to construing the words of a rule. Professor Bankman came close to this view in his defense of the partnership anti-abuse regulation: "I believe the Treasury has always had the residual, unstated power and responsibility . . . to interpret the literal language of the law according to its underlying purpose" because "all statutory regimens require purpose-based interpretation."[55] Schauer's approach, however, grounds the authority Bankman assigns to Treasury in the nature of rules more generally and gives decision-makers even greater latitude than does Bankman. Decision-makers use these common law doctrines not when they need to understand the words or meaning of a statutory or regulatory rule, but when the words of the rule seem inconsistent with justifications.

The origin of the common law tax doctrines is generally traced back to Judge Learned Hand in *Gregory*: "The meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear."[56] In Schauer's terms, to accept judicial use of the anti-abuse doctrines while denying the validity of codifying them is to ignore the important relationship between a rule and its justification. Schauer's presumptive positivism supports those who find standards such as business purpose or anti-abuse requirements implicit in the Code's statutory provisions because rules are, in his view, always linked to their justifications.

At same time, however, presumptive positivism teaches that rule-generating justifications must carry particular weight because any tax statute is part of a complicated set of interlocking rules. Decision-makers following presumptive positivism would hesitate before allowing a justification to trump the articulated rule. At least we would expect such to be the case in the absence of codifying the standard. The impact of codifying a standard moves us to the second strand of Schauer's analysis, the separation of powers. This second strand is a useful tool for viewing the tax shelter debate whether or not we accept Schauer's understanding of the relationship between rules and their justifications.

Critics who attack codification of judicial doctrines sometimes assert that the Treasury and the Internal Revenue Service, by virtue of the established judicial doctrines, already possess the authority they are attempting to establish in rules. Kenneth Kies, who was quoted above urging a strict formalism, also has written, "[p]ursuant to several 'common-law' tax doctrines, Treasury and the Service have the ability to challenge taxpayer treatment of a transaction that they believe is inconsistent

55. Joseph Bankman, *Stanford Professor Rebuts Criticism of Partnership Antiabuse Reg.*, 94 TAX NOTES TODAY 140-33 (1994), *available at* LEXIS, Fedtax Library, TNT file.
56. *Gregory*, 69 F.2d at 810-11.

with statutory rules and the underlying congressional intent."[57] Similarly, the American Bar Association Committee comments on the partnership anti-abuse rule asserted that existing judicial doctrines were adequate to police abuse.[58] Critics of this position have pointed out the logical inconsistency of arguing both that codification is undesirable because it will extend Treasury's authority and that codification is unnecessary because Treasury already has the necessary authority pursuant to the judicial doctrines.[59]

Once again, however, Schauer's analysis enables us to look at this question from a different angle. If purposive standards are implicit in the current rules, as both proponents and opponents of codifying the standards have argued, we must wonder about the effect of codifying these standards. The New York State Bar Tax Section, emphasizing that a substantive disallowance rule is not self-enforcing, has cautioned, "[a]ssuming adequate enforcement of existing law, however, it is not clear what would be added by enacting a substantive disallowance rule."[60] Indeed, some members of the New York State Tax Section believe "there is literally 'nothing to be gained' from a substantive disallowance rule that only applies to tax benefits that would have been disallowed in any case under a case law doctrine."[61]

Nonetheless, codifying a standard would be expected, at the very least, to have some effect on the calculus employed by judges acting as presumptive positivism in deciding whether to resort to these common law doctrines. It would make the standard more salient. In Schauer's terminology, codifying these justifications turn them into rules with "local priority."[62] Codification would thus lessen the weight to be assigned to the rule-generating justifications of certainty, predictability, and reliance.

Even some who support codifying standards suggest that this impact, although useful, might be small and primarily affect judges. Thus, Professor Bankman, speculating about Treasury's promulgating an anti-abuse regulation for corporate tax shelters, believes that such codification would "give the government an edge in any litigated matter" because "[c]ourts give much greater deference to a position clearly incorporated

57. Kenneth J. Kies, *A Critical Look at the Administration's 'Corporate Tax Shelter' Proposals*, 83 TAX NOTES 1463, 1478 (1999).

58. *See* Caudill, *supra* note 51.

59. *See* Bankman, *supra* note 55.

60. Scarborough, *supra* note 38.

61. *Id.*

62. SCHAUER, *supra* note 1, at 190-91. As Schauer explains:

> [T]he power of rules is increased within a rule system to the extent that rules have a *local priority*, both over their own justifications and over other more distant rules within the system. . . . Local priority need not be absolute to be a priority, any more than rules need be absolute in order to be rules. But given that existing legal systems are (contingently) such that events will frequently be conflicting controlled by rules more and less locally applicable, *some* degree of local priority is necessary to preserve in these systems a modicum of rule-based decisionmaking.

Id.

in regulations than the same position supported only by an interpretation of case law."[63] Professor Johnson also notes that "[a]nti-abuse rules are developed and applied in litigation."[64] Some members of the New York State Bar Association welcome anti-abuse rules to the extent they "provide a clear basis on which purported tax benefits may be disallowed and therefore encourage the courts to find against the taxpayer if the matter is ultimately litigated."[65]

Schauer helps us to see that codifying standards will do more than strengthen the ability of judges as presumptive positivism to deploy the standards that are already part of the judicial arsenal. Codifying these standards also will give administrative officers greater ability to attack taxpayer transactions. That is, codifying these standards as rules will change the decision-making calculus for administrative officials. It will do more than affect certainty, predictability, and reliance in the system. Such a change will have important consequences for separation of power by expanding the jurisdiction of administrative agents.

Of course, the courts have an opportunity to apply the common law doctrines only if some Internal Revenue agent has asserted that the taxpayer has abused some provision of the Code, be they the installment sale provisions at issue in *ACM v. Commissioner*[66] or the foreign tax credits at issue in *Compaq Corp. v. Commissioner*.[67] Agents and government litigators, however, know that they will win the case only if they can persuade a judge to consider the common law doctrines. It is the judge who must be persuaded to use the authority to go behind a rule to its purpose. Currently, these are doctrines for judges to wield.

Codifying these judicial doctrines would empower administrative agents to decide for themselves whether to follow the rule or to resort to its justification. While, as a matter of the first strand of Schauer's theory, the nature of presumptive positivism, this authority is implicit in the notion of rules, it is also true under the second strand, the impact of rules on separation of powers, that codifying the justification will increase the discretion of administrative agents. Many, of course, have made this obvious point. The New York State Bar Association's Ad Hoc Committee, for example, wrote that the corporate tax shelter provisions contained in the administration's Fiscal Year 2000 Budget raised questions regarding "the amount of discretion that should be granted to the administrative arm of our government in determining corporate tax policy."[68] Commenting on the proposals in the 2001 Budget, some members of the New

63. Joseph Bankman, *The New Market In Corporate Tax Shelters*, 83 TAX NOTES 1775, 1778 (1999); *see* Chevron U.S.A., Inc. v. Nat'l Res. Def. Council, 467 U.S. 837 (1984) (holding deference to administrative decisions when congressional intent not clear); Ellen P. Aprill, *Muffled* Chevron: *Judicial Review of Tax Regulations*, 3 FLA. TAX REV. 51 (1996).

64. Johnson, *supra* note 53.

65. Scarborough, *supra* note 38, at n.3.

66. 157 F.3d 231 (3d Cir. 1998).

67. 113 T.C. 214 (1999).

68. Ad Hoc Committee on Corporate Tax Shelters, *Comments on the Administration's Corporate Tax Shelter Proposals*, 83 TAX NOTES 879, 881 (1999).

York State Bar Tax Section expressed concern that "even a substantive disallowance rule that applies only in the narrowest of cases has the potential for being misunderstood, and misapplied" by IRS agents.[69] According to Kenneth Kies, enactment of the Fiscal Year 2000 proposals "would represent one of the broadest grants of authority ever given to the Treasury Department and more importantly, to IRS agents."[70]

Schauer's approach helps us see that these concerns reflect more than a decrease in the Big Three rule-generating justifications, although practitioner concerns are often expressed in terms of a decrease in the Big Three. Kenneth Gideon, for example, asserted, "[a]ntiabuse rules transfer that decision making process from the open and uniform arena of rulemaking to the uncertainties of the audit process and virtually assure that the results will vary from taxpayer to taxpayer."[71] Results vary from taxpayer to taxpayer. Currently, the shadow of the judicial doctrines hangs over all transactions. The crucial question underlying such objections is not the authority of administrative officials to make such decisions, but the wisdom of assigning it to them. Recall that Schauer directs us to view "rules not so much as implements for achieving predictability but as devices for the allocation of power."[72]

With some exceptions,[73] under the current state of matters, administrative agents apply the rules, and identify cases in which purposive rules might come into play, and courts decide whether purpose is allowed to trump the rules. Schauer also helps us understand this jurisdictional assignment. As his book explains, we do not always want the "rule-applier to determine whether following the rule is on the balance of reasons desirable on this occasion."[74] We prefer to have one set of decision-makers apply the rule and another determine whether the application is consistent with the rule's justification.

Schauer offers a reason for this separation of powers. He reminds us that in designing a rule-based regime, we need to "calculate the virtues of ruleness based not only on an assessment of the costs of errors of under- or over-inclusion, but also on an assessment of the incidence and consequences of those errors that are more likely when decision makers are not constrained by rules."[75] We believe our judges, whether Article I judges with life tenure or Article III judges on the Tax Court, to be disinterested. We believe that there is no systematic bias in judicial decisions in favor or against the taxpayer and that they are as likely to decide in favor of the taxpayer as against the taxpayer.

Practitioners worry that IRS agents, whose duty is to collect the revenue, are likely to err in the direction of finding abuse on the part of tax-

69. Scarborough, *supra* note 38, at 16 n.3.
70. Kies, *supra* note 57, at 1464.
71. Gideon, *supra* note 3, at 1001.
72. SCHAUER, *supra* note 1, at 98.
73. *See discussion infra* Part III.
74. SCHAUER, *supra* note 1, at 98.
75. Schauer, *Rules and the Rule of Law*, *supra* note 29, at 685.

payers. The fear is that the default rule in every close case will be to impose liability on the taxpayer. Practitioners' objection to codification of standards rests in good measure, and understandably enough, on their unease regarding revenue agents. To many practitioners, the current state of affairs achieves the regime Schauer would envision. We do not adhere slavishly to rules. In fact, we permit consideration of the rule's justification, and we assign that task not to the agents who apply the rules in order to collect revenue but to our disinterested judges.

In sum, Schauer's approach to rules helps us understand objections to codification of anti-abuse doctrines, whether by statute or regulation. By increasing the local priority of these common law doctrines, codification increases the power of administrative officials. Such a statement may seem a truism. The advantage of using Schauer's approach, however, is that it helps us to distinguish concerns about inconsistency and other violations of the Big Three from concerns about separation of power.

Schauer, however, does not cease analysis at this point. He also calls for consideration of the decision-making environment.[76] Such consideration, I believe, answers many of the critics' concerns about expanding the discretion of IRS agents. The response of Treasury and the IRS to grants or assertions of administrative discretion belie many of these concerns. As discussed further below, history shows that Treasury and the IRS have heeded the call of Kenneth Culp Davis, the dean of administrative law: "When legislative bodies delegate discretionary power without meaningful standards, administrators should develop standards at the earliest feasible time, and then, as circumstances permit, should further confine their own discretion through principles and rules."[77] Treasury and the IRS have frequently constricted broad grants and assertions of discretion.

III. ADMINISTRATIVE NARROWING OF ADMINISTRATIVE DISCRETION

Schauer posits that rules always carry with them the possibility of discretionary power. Administration of rules itself involves a considerable amount of discretion in deciding whether to enforce the rule in a particular case. The IRS is frequently accused of abusing this discretion. In 1998, highly publicized Senate Finance hearings held by Senator Roth on abuse by IRS agents gave rise to a new Taxpayer Bill of Rights with a variety of provisions to protect taxpayers against harassment by IRS agents.[78] Yet, a recent GAO Report disputed the charges of cronyism and abuse made during the hearings,[79] and data recently compiled by the

76. *See* SCHAUER, *supra* note 1, at 173.
77. KENNETH CULP DAVIS, DISCRETIONARY JUSTICE 55 (1969).
78. *See generally* Leandra Lederman, *Of Taxpayer Rights, Wrongs, and A Proposed Remedy*, 87 TAX NOTES 1133 (2000).
79. *See* General Accounting Office, *GAO Report on Allegations of IRS Taxpayer Abuse*, 2000 TAX NOTES TODAY 80-13 (2000), *available at* LEXIS, Fedtax Library, TNT File; Ryan J. Donmoyer, *Roth's IRS Abuse Hearings Take Another Pounding*, 87 TAX NOTES 463, 463 (2000).

IRS and the Treasury Inspector General for Tax Administration found that a significant number of complaints of harassment were unsubstantiated.[80]

We see similar responsible use of administrative power and discretion if we move to anti-abuse rules that have been codified. Consider the partnership anti-abuse regulations that raised such a storm of protest. One practitioner declared, "I don't think the bar has seen such an extraordinary abrogation of authority since Watergate;" another decreed that the date of the notice of rulemaking was "a day that will live in infamy."[81] Yet, the IRS recently released a 1998 ISP Settlement Guideline addressing the partnership anti-abuse regulation.[82] While the guideline asserts the authority of the IRS to recast abuse partnership transactions and summarizes the rule, it also includes a biography of ten articles criticizing the regulations and only three defending them. Two of the most ardent critics of the regulation predict "that an IRS field agent reading the *Settlement Guideline* will read into the paper's unique bibliography the message that pursuing a partnership anti-abuse case should not be undertaken lightly."[83] I agree. The administrative agency is voluntarily narrowing its discretion, out of concerns for both the Big Three and separation of powers.

The history of section 482, with its very general language and enormous grant of authority to the Secretary,[84] offers even greater assurance that

80. *See* Amy Hamilton, *No Misconduct Found in 95 Percent of Alleged IRS Harassment Cases*, 88 TAX NOTES 978, 978 (2000).

81. Douglass Antonio et al., *Chicago Group Calls for OMB Investigation of Treasury's Decision Not to Analyze Partnership Antiabuse Reg's Effect on Economy*, 94 Tax Notes Today 142-38 (1994), *available at* LEXIS, Fedtax Library, TNT File; *see* Sheldon I. Banoff, *Anatomy of An Antiabuse Rule: What's Really Wrong With Reg. Section 1.701-2*, 66 TAX NOTES 1859 (1995); Caudill, *supra* note 51; Richard Lipton, *Controversial Partnership Anti-Abuse Regs. Raise Many Questions*, 81 J. TAX'N 68 (1994).

82. *ISP Settlement Guideline Addresses Partnership Antiabuse Rule*, 2000 TAX NOTES TODAY 105-14 (2000), *available at* LEXIS, Fedtax Library, TNT File.

83. Sheldon I. Banoff & Richard M. Lipton, *IRS Settlement Guidelines on Subchapter K Anti-Abuse Rule*, 93 J. TAX'N 64, 65 (2000).

84. Section 482 currently provides:

> In the case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

I.R.C. § 482 (1986). As Bittker and Eustice note, the provision "seems to amalgamate several pervasive themes and policies of the tax law: tax-avoidance principles, the assignment of income doctrine, general deduction theories, and clear reflection of net income under the parties' accounting methods." BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.20[1][c] (6th ed. 1999). Moreover, they explain, "it lays down no principles to determine *when* taxes are being evaded or *when* income is not clearly reflected." *Id.*

administrative officials will act to narrow codified anti-abuse authority and that judicial oversight will help ensure that they do so. At the same time that the New York State Bar Association criticized codification of anti-abuse standards for corporate tax shelters, it acknowledged that other statutory anti-abuse provisions, such as sections 482, 7701(f) and 7701(l) have operated well. "[A] statute like Section 482 of the Code can, even though it merely reiterates already extant legal concepts, develop into a 'repository' of organized guidance and provide a clear basis for challenge and responses."[85] The history of section 482, however, is more complicated than the New York State Bar acknowledges. At the time of its predecessor's introduction, the provision did far more than reiterate already extant legal concepts. In comparison, codifying common law anti-abuse doctrines in the case of corporate tax shelters would seem to be an easy case.

Section 482 traces its origin back more than seventy years. It has its source in regulations, rather than in either statutory provisions or judicial interpretations. That is, it originally represented authority that the Internal Revenue Service explicitly gave itself. Regulations promulgated under the 1917 War Excess Profits Tax[86] required every corporation "to describe in its return all its intercorporate relationships with other corporations with which it is affiliated" and, if necessary, authorized the Commissioner of Internal Revenue to require a consolidated return.[87]

These regulations were codified as a statute in section 240 of the Revenue Act of 1918.[88] The version of the provision enacted in 1921 included language strongly reminiscent of today's section 482. The 1921 statute authorized the Commissioner to "consolidate the accounts of . . . related trades and businesses, in any property case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deduction or capital between or among such related trades or businesses."[89]

When this provision became section 45 of the Internal Revenue Code, as part of the Revenue Act of 1928, elimination of the consolidated return provisions required some changes in the statutory language, changes that closely parallel the current provision.[90] Section 45 permitted the Commissioner "to distribute, apportion or allocate gross income or deductions between or among [two or more] trades or businesses, if he determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such trades or businesses."[91] Section 482's language has undergone little

85. Scarborough, *supra* note 38, at n.3.
86. War Revenue Act of 1917, ch. 63, 40 Stat. 300 (1917).
87. Reg. 41, art. 77, 78 (1918).
88. 40 Stat. 1057, Pub. L. No. 254 (1918).
89. Revenue Act of 1921, ch. 136, § 240(d), 42 Stat. 227, 319 (1921).
90. *See* H.R. Rep. No. 70-2, at 16-17, *reprinted in* J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861, at 522 (1953) [hereinafter SEIDMAN, 1938-1861].
91. Revenue Act of 1928, ch. 852, § 45, 45 Stat. 791, 806 (1928).

change since 1928.[92] The most important change was the addition in 1986 of a second sentence governing intangible property.[93]

Neither has the purpose changed considerably over the years. The legislative history to the 1918 provision explained that "consolidation . . . prevent[s] evasion which cannot be successfully blocked in any other way. Among affiliated corporations it frequently happens that the accepted intercompany transfer assigns too much income . . . to Company A [and] not enough to Company B."[94] The Senate Finance Committee explained that the purpose of the 1921 provision "was to prevent subsidiaries, especially foreign subsidiaries, from the 'arbitrary shifting of profits among related businesses."[95] The legislative history of the 1928 provision speaks of the need to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking)."[96]

Section 482 and it predecessors give the Internal Revenue Service enormous discretion to decide whether taxes are being evaded or income is not being clearly reflected, and this authority has withstood challenge. In 1935, *Asiatic Petroleum Co. v. CIR* rejected a constitutional challenge to section 45.[97] The Second Circuit, citing the then-recent case of *Gregory v. Helvering*,[98] wrote,

> even without such a statute as section 45, many cases have gone very far in disregarding formal transfers introduced into corporate transaction for the purpose of escaping taxation . . . . If anticipatory arrangements intended to circumvent taxes may be disregarded by the courts without the aid of statutory authority, a statute authorizing the Commissioner to disregard them under similar circumstances cannot be unconstitutional.[99]

92. The 1934 Act added the word "organizations" to the phrase "trades or businesses" in order to confirm that the provision is applicable to all types of business activity. H.R. Rep. No. 73-704, at 24 (1934), *reprinted in* SEIDMAN, 1938-1861, *supra* note 90, at 323. The 1944 Act changed the phrase "gross income or deductions" to "gross income, deduction, credits or allowances." Revenue Act of 1943, ch. 63, § 128(b), 58 Stat. 48 (1944). These additions were made to make clear that § 45 was not narrower than the newly enacted § 129 of the 1939 Code (currently section 269). H.R. Rep. No. 78-871 at 50, *reprinted in* SEIDMAN, J.S. SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS 1953-1939, at 1475 (1953) [hereinafter SEIDMAN, 1953-1939].

93. Section 1231(e) of the Tax Reform Act of 1986, 100 Stat. 2085, 2562-63(1986), added the following sentence to § 482: "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

94. S. Rep. No. 65-617, at 8-9 (1918), *reprinted in* SEIDMAN, 1938-1861, *supra* note 90, at 923.

95. S. Rep. No. 67-275, at 19 (1921), *reprinted in* SEIDMAN, 1938-1861, *supra* note 90, at 875.

96. H.R. Rep. No. 70-2, at 16-17 (1982), *reprinted in* SEIDMAN, 1938-1861, *supra* note 90, at 522. Bittker and Eustice describe the principal function of section 482 is much the same terms: "the prevention of artificial shifting, milking, or distorting of the true taxable incomes of commonly controlled enterprises." BITTKER AND EUSTICE, *supra* note 84, at ¶ 13.20[1][a].

97. 79 F.2d 234 (2d Cir. 1935).

98. 293 U.S. 465 (1935).

99. *Asiatic*, 79 F.2d at 238.

Congress rejected challenges to the Commissioner's discretion in 1934, 1948, and 1951.[100] In hearings before the House Ways and Means Committee in 1948, one witness urged

> Taxation should be by law and not by man. In section 45 that theory is more or less demolished. . . . Under that provision the sky is the limit and liabilities are at the whim and caprice of an administrative officer. . . . [T]he section does not establish any rules or practice or condemn intercompany business transactions of particular character but vests in the Commissioner of Internal Revenue unlimited and unrestricted power to increase the liability of various affiliated businesses in such manner as he may see fit.[101]

Congress rejected the plea to repeal section 482. Congress has also rejected two proposed amendments to section 482, one in 1955 targeting captive insurance companies and the other in 1962 establishing a multifactor formula for allocating income of multinational corporations, in favor the of the broad administrative authority of section 482.[102]

The Commissioner has exercised this administrative authority through regulations that have grown increasingly elaborate over the years. Regulations issued in 1935 under section 45 set out an arm's length standard, but did not mandate the use of any particular allocation method.[103] In the 1930s, however, with few U.S. companies with multinational affiliates, the provision had little impact and was known as the "silent policeman."[104]

As multinational issues grew, so did the impact of section 482, and in 1962 Congress directed Treasury to "explore the possibility of developing and promulgating regulations under [section 482] which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income."[105] Lengthy regulations were issued in proposed form in 1965, withdrawn and reproposed in 1966, and issued in final form in 1968.[106] A press release accompanying the 1968 regulations promised that they would be administered "in a spirit of rea-

100. *See* Francis Allegra, *Section 482: Mapping the Contours of the Abuse of Discretion Standard of Judicial Review*, 13 VA. TAX. REV. 423, 441 n.51 (1994) (citing Hearings Before the House Comm. On Ways & Means on the Revenue Revision of 1934, 73d Cong, 1st Sess. 186-87 (statement of George Morris); Hearings Before the House Comm. On Ways and Means on Proposed Revisions to the Internal Revenue Code, 80th Cong. 1st Sess. 3324 (1948) (statement of C.S. Stein); Hearings Before the Senate Comm. on Finance, 82d Cong., 1st Sess. 1867-68 (1951) (statement of A. Hyman)).

101. *Id.* at 441 n.52 (citing Hearings Before the House Comm. On Ways & Means on Proposed Revision of the Internal Revenue Code, 80th Cong. 1st Sess. 3241 (1948) (statement of Arthur B. Hyman)).

102. *See id.* at 443-44 nn.54-56.

103. Treas. Reg. § 45-1(b)(1935).

104. Warren C. Seieroe & Lawrence Gerber, *Section 482—Still Growing at the Age of 50*, 46 TAXES 893, 894 (1968).

105. *See* Allegra, *supra* note 100, at 447 (citing H.R. Conf. Rep. No. 2508, at 19 (1962)).

106. 30 Fed. Reg. 4256 (1965); 31 Fed. Reg. 10394 (1966); T.D. 6952, 1968-1 C.B. 218.

sonableness."[107] These regulations, like those issued in 1935, adopted the arm's length standard, but also established special rules for specific kinds of intercompany transactions, including performance of services, the licenses or sale of intangible property, and the sale of tangible property.

Section 482 received increased attention in the late 1980s and in the 1990s. At the same time that it added a sentence to section 482 regarding intangibles, Congress directed the Treasury Department to conduct a "comprehensive study of intercompany pricing rules" and to consider modifying the regulations.[108] The Treasury Department issued its White Paper on section 482 in October 1988.[109]

A series of extraordinarily lengthy and complicated proposed, temporary, and final regulations followed. Regulations were proposed early in 1992 implementing many of the suggestion in the White Paper. Temporary and proposed regulations modifying the 1992 proposed regulations were issued on January 13, 1993.[110] Final regulations were issued in 1994[111] and 1995.[112] The section 482 regulations now run almost 100 pages.[113] Bittker and Eustice say of them that "like all versions of these regulations, there are no bright lines or safe harbors. . . . Moreover, it is clear that § 482 pricing issues are even more fact-driven under the final regulations, a situation that does not make for ready predictability."[114] They also conclude, however, that "as a remedial tool, § 482, especially as augmented by the regulations, can properly be described as more precise than underlying substantive rules" such as tax-avoidance principles, the assignment of income, doctrine, or general deduction theories "because it permits all aspects of the income distortion to be corrected."[115]

Section 482 thus teaches that broad anti-abuse statutory standards become more detailed and articulated over time. The attention received reflects the importance of the transactions governed; section 482 grew with multinational operations and issues. Section 482 also demonstrates that a broad anti-abuse statute, even one that by its terms seems to grant enormous discretion to administrative officers, does not displace judicial oversight. Courts have not hesitated to overturn the Commissioners' de-

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107. *See* James S. Eustice, *Affiliated Corporations Revisited: Recent Developments under Section 482 and 367*, 24 TAX. L. REV. 101, 102 (1968-96) (citing Treasury Department Release F-1217).

108. *See* H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-638 (1986), *reprinted in* 1986-3 C.B. (vol. 4) 638.

109. *See* Department of the Treasury, *A Study of Intercompany Pricing*, 8 TAX NOTES TODAY 213-74, *available at* LEXIS, Fedtax Library, TNT file.

110. T.D. 8470 (Jan. 1, 1993).

111. T.D. 8852 (July 1, 1994)

112. T.D. 8632 (Dec. 19, 1995). The 1995 regulations relate specifically cost-sharing in connection with the statutory language added in 1986 regarding intangibles. In 1996 T.D. 8670 (May 13, 1996) eliminated the requirement that developed intangibles be used in the active conduct of business. In addition, on March 6, 1998, the IRS proposed a large set of regulations under section 482 related to income earned in global securities dealing operations. 63 Fed. Reg. 11,177 (1998).

113. *See* Treas. Reg. §§ 1.482-.0 to 1.482-8 and 1.482-1A to 1.482-2A.

114. BITTKER & EUSTICE, *supra* note 84, at ¶ 13.20[6][3] (2000 Supp.).

115. *Id.* at ¶ 13.29[1][c].

terminations under section 482 as arbitrary, capricious or unreasonable, or otherwise limit asserted administrative authority.[116]

Moreover, in the case of section 482, administrative developments include not only regulations, but also a formal mechanism known as an Advanced Pricing Agreement or ("APA"), under which the taxpayer and the IRS agree in advance that a specific set of related party transactions would satisfy section 482.[117] In developing these procedures, the IRS has acted to promote rule-generating justifications, here, in particular predictability. Another rule theorist, Louis Kaplow, explains that "[a]rguments about and definitions of rules and standards commonly emphasize the distinction between whether the law is given content *ex ante* or *ex post*."[118] Using this distinction, the APA mechanism transforms the standard of section 482 into a rule for the particular taxpayer.

Perhaps most telling is the history related to spin-offs such as the one at issue in *Gregory*. The Revenue Act of 1924 permitted tax-free spin-offs.[119] It provided that the transfer by a corporation of part or all of its property to a second corporation constituted a tax-free reorganization if the first corporation or its stockholders (or both) were in control of the second corporation immediately after the first transfer and that the shareholders of the first corporation recognized no gain if stock of the second corporation was distributed to them as part of the reorganization plan.[120]

As is well-known in tax law history, the Supreme Court in *Gregory v. Helvering*[121] affirmed the decision of the Second Circuit finding that satisfying the literal language of the statute did not ensure tax-free treatment because the transaction lacked a business purpose. The Court declared:

> When [the statute] speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. . . . [T]he transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.[122]

The *Gregory* decision, from the time of its issuance, was widely criticized for undermining certainty, predictability, and reliance—the Big Three

116. *See generally* Allegra, *supra* note 100; 57 Fed. Reg. 3571; Eli Lilly & Co., 84 T.C. 96 (1985), *aff'd in part*, 856 F.2d 885 (7th Cir. 1988); G.D. Searle & Co. v. Comm'r, 88 T.C. 252 (1987); Merck & Co. v. U.S., 24 Cl. Ct. 73 (1991); U.S. Steel Corp. v. CIR, 607 F.2d (2d Cir. 1980).

117. *See* Rev. Proc. 96-53, 1996-2 C.B. 375; Rev. Proc. 91-22, 1991-1 C.B. 542.

118. Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 557 (1992); *see also* SCHAUER, *supra* note 1, at 131.

119. For another discussion of this history, see Steven A. Bank, *Taxing Divisive and Disregarded Mergers*, 34 GA. L. REV. 1523, 1577-81 (2000).

120. Revenue Act of 1924, § 203(c), 43 Stat. 256 (1924).

121. 293 U.S. 465 (1935).

122. *Id.* at 469-70.

rule justifications.[123]

Even before the Supreme Court issued its opinion, however, Congress was reconsidering the reorganization provisions. The Treasury Department, in its 1933 testimony before the Committee on Ways and Means, called upon Congress to redraft the reorganization provisions completely because they were overspecific and denied Treasury leeway in administration of the law. Treasury did not want to rely on courts to interpret specific sections in order to carry out the intent of the statute. In language strongly reminiscent of today's debates, Treasury urged Congress:

> to express in the statute as simply as possible the general plan for dealing with these transactions, leaving to the Department as in other cases the power to make rules and regulations to carry out the congressional intent .... In the cases of complicated subjects of this kind, it is almost impossible to foresee all the ingenious devices which lawyers will invent and to provide against them expressly in the statute. The more effective plan is to place the responsibility squarely upon the Department administering the law from day to day. It can readily amend its regulations to cover new situations as they arise.[124]

Congress did not heed Treasury. Instead, in the Revenue Act of 1934, it eliminated the statutory provision allowing the spin-off.[125] Legislative history of this change explains that under the earlier provision corporations "found it possible to pay what would otherwise be taxable dividends, without any taxes upon their shareholders."[126] The committee believed that this means of avoidance should be ended.[127]

Authority for a tax-free spin-off did not reappear until 1951, when Congress amended the 1939 Code to permit a tax-free spin-off of the common stock of a subsidiary under section 112(b)(11). This statute required post-distribution conduct of two or more trades or businesses and that the transaction not be used principally as a device for the distribution of earnings and profits.[128] The 1951 statute did not explicitly require a business purpose, although the legislative history stated that tax-free spin-offs were to be permitted only for distributions "for legitimate business purposes" not related to any desire to make a distribution of earnings and

123. *See* Note, *Corporate Reorganization to Avoid Payment of Income Tax*, 45 YALE L.J. 134, 140 n.38 (1936) (citing articles).

124. Statement of the Acting Secretary of the Treasury Regarding the Preliminary Report of a Subcommittee of the Committee on Ways and Means Relative to Methods of Preventing the Avoidance and Evasion of the Internal Revenue Laws Together with Suggestions for the Simplification and Improvement Thereof (1933).

125. *See* Revenue Act of 1934, 48 Stat. 680 (1934). Bittker and Eustice write, "[h]ad Congress withheld its legislative hand until after the Supreme Court's decision, it might have decided that the courts could be trusted to distinguish legitimate spin-offs from tax-avoidance devices." BITTKER & EUSTICE, *supra* note 84, ¶ 11.01[2][a].

126. H.R. Rep. No. 704, at 14 (1934), *reprinted in* SEIDMAN, 1938-1861, *supra* note 90, at 338.

127. *See id.*

128. Revenue Act of 1951, ch. 521, § 317, 65 Stat. 493 (1951) (adding Section 112(b)(11) to the 1939 Code).

profits.[129]

Just three years later, as part of the 1954 Code, Congress replaced section 112(b)(11) with section 355. Section 355, like its predecessor, requires the post-distribution active contact of two or more businesses and that the transaction not be a device for the distribution of earnings and profits. Although commentary generally assumed that the device prohibition served to codify *Gregory* and its business purpose requirement, the statutory language does not require a business purpose.[130]

Regulations published in 1955 included an explicit business purpose requirement under section 355, but only in connection with the distribution of shares.[131] These section 355 regulations required examination of the entire transaction to see if it was intended as a device, but referred to regulations under section 368, the reorganization provisions, for a general business purpose requirement.[132]

The Internal Revenue Service announced in 1964 that it would update the section 355 regulations,[133] but the proposed regulations did not appear until 1977. Perhaps the most important change proposed was a new emphasis on business purpose independent from the device prohibition. Proposed regulation 1.355-2 stated that section 355 requires of the taxpayer "real and substantial nontax reasons germane to the business of the corporation." According to one contemporary commentary, it was the "opinion of the authors that one of the primary emphases of the proposed regulations was to announce to taxpayers that business purpose and device are two separate, equal, unrelated requirements."[134] Another piece suggested that the regulations reflected judicial developments under section 355 in the years since its enactment and original regulations.[135]

Many reacted with horror to what they saw as a new view of the business purpose doctrine. Some denied the Treasury authority to introduce it. The authors quoted above also had this to say:

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129. S. Rep. No. 781, at 58 (1951), *reprinted in* SEIDMAN, 1938-1861, *supra* note 90 at 1566.

130. *See* Charles S. Whitman, III, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1204 (1968).

131. Treas. Reg. § 1.355-2(b), (c) (1955). Treas. Reg. §1.355-2(c) (1955) provided:

> The distribution by a corporation of stock or securities of a controlled corporation to its shareholders with respect to its own stock or to its security holders in exchange for its own securities will not qualify under section 355 where carried out for purposes not germane to the business of the corporations.

132. Treas. Reg. § 1.355-2(c) (1955) ("All the requisites of business and corporate purposes described under § 1.368 must be met to exempt a transaction . . . under this section").

133. Rev. Rul. 64-17, 1964-C.B. 579.

134. Thomas R. Helfand & Brian D. Lafving, *Filling the Serbonian Bog with Quicksand—Proposed Section 355 Regulations Further Obscure Corporate Separations—Part 1*, 5 J. CORP. TAX'N 345, 350 (1978); *see also* John W. Lee, *Proposed Regs. Under 355 Overhaul Device Test and Single-Business Divisions*, J. TAX'N 194, 194 (1977).

135. New York State Bar Association Tax Section Committee on Reorganizations, *Report on Proposed Section 355 Regulations*, TAXES 656, 657 n.8 (1977) (citing Comm'r v. Wilson, 353 F.2d 184 (9th Cir. 1964); Rafferty v. Comm'r, 452 F.2d 767 (1st Cir. 1970)).

> [T]he business-purpose requirement is a judicially mandated doctrine which is not reflected in the statute. The courts have the sole authority to determine the nature and extent of the doctrine. Although the regulations may provide rules which are not encompassed by the statute, the courts are not bound to follow them. . . . because the doctrine is strictly one of judicial origin capable of judicial development absent *legislative* intervention.[136]

Other commentators at the time also criticized the business purpose requirement.[137]

The proposed regulations were not finalized until 1989, almost twelve years after they were proposed.[138] The preamble to the final regulations acknowledged criticism of requiring an independent business purpose for a transaction, but preserved this requirement.[139] Under the final regulations the business purpose requirement, while closely related to the device prohibition, is explicitly made an independent requirement:

> Section 355 applies to a transaction only if it is carried out for one or more corporate business purposes. A transaction is carried out for a corporate business purpose if it is motivated, in whole or substantial part, by one or more corporate business purposes. The potential for the avoidance of Federal taxes by the distributing or controlled corporations (or a corporation controlled by either) is relevant in determining the extent to which an existing corporate business purpose motivated the distribution. The principle reason for this business purpose requirement is to provide nonrecognition treatment only to distributions that are incident to readjustments of corporate structures required by business exigencies and that effect only readjustments of continuing interests in property under modified corporate forms. This business purpose requirement is independent of the other requirements under section 355.[140]

Practitioners viewed the final regulations as not only clarifying this requirement by revising and adding examples, but also strengthening it. As one article characterized them:

> [T]he final Section 355 Regulations significantly fortify the business purpose test. Once taken for granted by many practitioners, this test may now be difficult to satisfy. Not only will the Service examine alternative means for accomplishing the stated business purpose, but the presence of Federal tax savings at the corporate level—such as a subsequent S election will draw further scrutiny.[141]

136. Thomas R. Helfand & Brian D. Lafving, *Filling the Serbonian Bog with Quicksand—Proposed Section 355 Regulations Further Obscure Corporate Separations—Part 2*, 5 J. CORP. TAX'N, 53, 68 (1978).

137. *See* Katherine Corinne Hall, *Comments: Internal Revenue Code Section 355: Recent Trends*, 31 SW. L.J. 523, 538-39 (1977) (citing other commentators).

138. T.D. 8238, 54 Fed. Reg. 283 (Jan. 5, 1989).

139. *See id.*

140. Treas. Reg. § 1.355-2(b) (1955).

141. Mark J. Silverman, Kevin M. Keyes, and Pamela C. Berry, *What Is A Business Purpose Under the Section 355 Regs?*, 71 J. TAX'N 4, 9 (1989). As they go on to note, "The business purpose test, as tightened by the Regulations, clearly reflects GU repeal." *Id.* After the 1986 Tax Reform Act, section 355 was the last surviving method of distributing

For example, the regulations, specify that a section 355 transaction is permissible only if the business problem cannot be solved by another tax-free transaction that is neither impractical nor unduly expensive.[142]

With the importance now accorded business purpose, the IRS continues to give taxpayers further guidance on this requirement.[143] Revenue Procedure 96-30 gives detailed guidelines that the IRS uses for ruling purposes in evaluating whether a distribution satisfies the business purpose requirement.[144] The Appendix to the Revenue Procedure lists nine categories of business purpose, including providing an equity interest to a key employee, facilitating a stock offering or borrowing, resolving management or customer problems, and protecting one business from the risks of another.[145] Both the Revenue Procedure and the Appendix carefully note that the business purposes listed in the Appendix are not an exclusive list.

In sum, business purpose as a requirement for spin-offs began as a judicial doctrine in *Gregory*. It was not explicitly incorporated into the statutory codification of the concerns reflected in *Gregory*. The business purpose requirement began to take a key role in administrative understanding of section 355 with the notice of proposed rulemaking in 1977 and took on even more importance with the repeal of the *General Utilities* doctrine. It is now an issue for which taxpayers can and do obtain private letter rulings to ensure certainty *ex ante* about satisfying its requirements.

As codified in the section 355 regulations, the business purpose requirement reflects its own arc of development. The business purpose requirement under the section 355 regulations, for example, is more strict than under the section 368 regulations.[146] Nonetheless, taxpayers and their advisors have learned to live with the section 355 business purpose requirement, as the dozens of private letter rulings blessing section 355 transactions show.[147] This requirement has not shut down section 355 spin-offs. Codification of the judicial doctrine has neither proved unworkable nor destroyed the doctrine. Business purpose as an anti-abuse

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tax-free appreciated corporate assets. At the time the section 355 regulations were finalized much of the commentary emphasized business purpose. *See also* Ross S. Friedman & P. Anthony Nissley, *New Regs. Provide Rules for Avoiding Tax in Spin-offs, Split-offs and Divisive Reorgs*, 42 TAX'N FOR ACCT. 206 (1989); Samuel M. Maruca, *Corporate Separations: The § 355 Final Regulations*, 30 TAX MGM'T MEMORANDUM 119 (1989); *Current Tax Developments, Temporary and Final Regulations*, 17 TAX'N FOR LAW. 2 (1989).

142. Treas. Reg. § 1.355-2(b)(30); Treas. Reg. § 1.355-2(b)(5), ex. 3-5.

143. *See, e.g.*, Rev. Rul. 88-34, 1988-1 C.B. 115.

144. Rev. Proc. 96-30, app. A., 1996-19 I.R.B. 8.

145. *See id.*

146. *See* MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS, AND BUYOUTS ¶ 1005, at 10-38 (1999).

147. *See, e.g.*, Priv. Ltr. Rul. 2000-30-17 (Oct. 21, 1999); Priv. Ltr. Rul. 80-25-054 (Mar. 26, 1980); Priv. Ltr. Rul. 90-28-098 (July 13, 1990); Priv. Ltr. Rul. 72-1128-0750A (Nov. 28, 1972).

doctrine continues to play a role in judicial decisions.[148]

The history of the business purpose requirement under the section 482 and section 355 regulations, then, should reassure the New York State Bar and others that codifying anti-abuse standards will not undermine the development of common law doctrines. More generally and more importantly, it demonstrates how, in exercising discretion under such broad standards as section 482 or the section 355 regulations, or Treasury and the IRS act in ways to make the justifications more predictable, reliable, and certain. They make these codified standards more rule-like, limiting their own discretion in the interest of the justifications for having rules. Treasury's own actions, particularly to the extent private letter rulings are available, give substantial weight to the Big Three.

IV. THE CASE OF CORPORATE TAX SHELTERS

This history gives solace and support to those who would codify judicial doctrines. Such codification will empower Treasury and the IRS in a way that judicial victories do not. Administrative agencies will be careful of any codified discretion exercising this discretion cautiously and also voluntarily constricting it through procedures, regulations, and rulings.

But not all of this history reassures. Sections 482 and 355 developed over decades. A key concern about the current corporate tax shelters is that we no longer have the luxury of leisurely elaboration and evolution because of the emergence of a tax shelter industry constantly developing and marketing tax products as developed.[149] Regarding any particular shelter, Treasury and the IRS are able to act only after the fact and prospectively and in so doing encourage promoters constantly to develop new tax shelters.[150]

In addition, the opinions written by tax lawyers play an important role in the marketing of today's tax shelter. As Professor Bankman has written, "the opinion provides insurance against tax penalties; more speculatively, it also provides psychological support to executives and their advisors."[151] Bankman continues,

> The opinion writing process is by all accounts odd, in large part because the law is so ill-defined. Virtually all tax shelters comply with the literal language of a relevant (and perhaps the most relevant) statute, administrative ruling, or case. The issue presented is whether the result is so at odds with economic reality and/or tax theory that it ought to be trumped by a competing legal rule. Frequently, the only competing legal rule is one encapsuled, perhaps, in common law doctrines such as business purpose, substance over form, step transaction and sham transaction. . . [T]hese doctrines are

148. *See, e.g.*, Winn-Dixie Stores Inc. v. Comm'r, 113 T.C. 21 (1999); Caruth v. United States, 688 F. Supp. 1129 (N.D. Tex. 1988), *aff'd*, 865 F.2d 644 (5th Cir. 1989); Wortham Mach. Co. v. United States, 521 F.2d 160 (10th Cir. 1975).

149. *See* Bankman, *supra* note 63, at 1780.

150. *Id.* at 1780-81.

151. *Id.* at 1782.

by their nature analytically elusive (some might describe these doctrines in harsher terms) and are interpreted only in a few cases.[152]

In other words, tax lawyers are also decision-makers faced with the task of applying a rule or resorting to its justification.

As with administrative officials, Schauer directs us to ask in what direction these decision-makers are likely to err. Private practitioners fear that administrative officials exercise the judicial doctrines to err in favor of the FISC and against taxpayers. Administrative officials fear that tax lawyers, charged with the duty of representing their client zealously, are likely to err in favor of their clients, and thus they may be too likely to ignore these judicial doctrines.

Private practitioners have suggested that judicial doctrines need to be made more salient in the opinion-writing process. Recently, both the New York State Bar Association and the American College of Tax Counsel recommended that Circular 230 be amended to require lawyers to address the applicability of the common-law doctrines.[153] The New York State Bar Association recommends that any reasonable cause opinion "should be required to specifically address and opine on all applicable judicial doctrines, including the business purpose, step transaction, economic substance, substance over form and sham transaction doctrines, as well as applicable statutory and regulatory doctrines, such as clear reflection of income and anti-abuse rules."[154]

As discussed above, codifying these judicial doctrines would make them even more salient. Currently, application of these judicial doctrines is believed by many to be under-inclusive. Many fear that if the doctrines were codified, their application would become over-inclusive thereby chilling legitimate business transactions.[155] Deciding whether over-inclusion or under-inclusion produces the greatest danger is an empirical question—how many tax shelters and at what size would be stopped by codifying judicial doctrines versus how many legitimate transactions and at what size would be stopped by this codification.

It is always difficult to predict the impact of an anti-abuse rule on legitimate transactions and the extent to which the business community will be able to adjust to any new rules. Whether in the case of today's corporate tax shelters under-inclusion or over-inclusion poses the greater danger thus comes down to a matter of judgment. The question of judgment, however, must extend beyond the limits of the corporate tax shelter. An additional consideration is whether the presence of tax shelters under-

152. *Id.*

153. James E. Merritt, *Association Recommends Changes to Circular 230,* 2000 TAX NOTES TODAY 158-44 (2000), *available at* LEXIS, Fedtax Library, TNT File; Robert H. Scarborough, *NYSBA Tax Section Proposes Changes to Circular 230,* 2000 TAX NOTES TODAY, *available at* LEXIS, Fedtax Library, TNT File 150-31 (Aug. 3, 2000).

154. Scarborough, *supra* note 38.

155. *See* Kenneth J. Kies, *A Critical Look at 'Corporate Tax Shelter' Proposals,* 83 TAX NOTES 1463 (1999); Peter Faber, *June 16, 2000 Letter to the Editor,* 87 TAX NOTES 1666 (2000); Peter Faber, *July 7, 2000 Letter to the Editor,* 88 TAX NOTES 279 (2000).

mines respect for the tax system in general and encourages abuse in other areas of tax law.[156] The tax shelter debate ultimately forces us to go beyond the justifications embedded in judicial doctrines such as business purpose to far broader justifications behind the income tax itself, such as vertical and horizontal equity.[157]

While such broad considerations, of course, are beyond the scope of this paper, it has been its aim to suggest that tax policy will benefit from considering Professor's Schauer's approach to rules, which encourages, even requires us, to consider the questions of purpose and justification both in addressing corporate tax shelters and thinking more generally about the tax code. His theory supports attempts to require consideration of justifications through some codification of them, but does not dictate we do so. It moves us beyond questions of authority to questions of the wisdom of such an approach. Even if we do not accept his emphasis or justification for rules, he urges us to consider concerns about separation of powers and the kinds of errors likely to be made. His theory of rules does not tell us which is the wisest approach, but it does help us to decide what questions to ask and where to focus our analytical energies.

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156. *See* Faber, *July 7, 2000 Letter to the Editor*, *supra* note 157.

157. JOSEPH DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY 21-25 (2d ed. Lexis Law Publishing 1999).